A dovish Fed and an inverted yield curve spark market concerns

Weekly Market Compass: Also, will the third time be a charm for Theresa May's Brexit plan?

Mar 25, 2019 | Kristina Hooper, Chief Global Market Strategist

Monetary policy disruption was on full display last week: The Federal Reserve (Fed) announced a momentous change to its normalization plan, the yield curve inverted and sparked investor concerns, and a noted Fed critic was nominated to the central bank's Board of Governors.

Stocks rallied after the Fed's dovish actions

What **the Fed did at its March policy meeting** (altering the dot plot to reflect zero rate hikes in 2019 and planning to end balance sheet normalization in September) raised questions about just how weak global growth must be. Fed Chair Jay Powell tried to reassure markets during his press conference, saying that the US economy is in a good place and that the global slowdown is modest. But those comments don't sync with the dramatic change the Fed has made in the last few months. We have gone from balance sheet normalization being on auto pilot to balance sheet normalization being tapered and ending in a matter of months. We have gone from talk of three rate hikes in 2019 to none. And fed funds futures are suggesting a 60% probability of a rate cut by year end.[1] Markets are now far more concerned about the growth outlook, and that's being reflected in Treasury yields, which are a far better fear gauge than the VIX index, in my view. This is creating an expectation that other central banks may become more dovish as well.

The Fed's dovish turn was a momentous event and should create a far more supportive environment for risk assets. Having said that, there is clearly some fear out there, which was reflected in Treasury yields. However, not surprisingly, equities initially held up well, reflecting the Fed's far more dovish stance and the markets' hope that Powell is not wrong when he says that the US economy is in a good place and that the global slowdown is modest.

The yield curve inverted, spooking investors

Then the yield curve inverted on Friday, March 22. The yield curve inversion, coming quickly after the Fed's dramatic "about face," helped to undermine investor confidence. That's because investors began to question whether the global slowdown really is a modest one. Those fears were reinforced by weak European data and continued concerns about the US-China trade situation. I continue to believe tariffs are a geopolitical disruption that poses a significant threat to the global economy. There is an old saying that curses are like young chickens; they always come home to roost. In this case, tariffs are young chickens – I think we are beginning to see the negative effects of their roosting, with the potential for more to come.

At the end of the day, we have to remember that an inverted yield curve doesn't cause a recession – but in recent years it has been a good indicator that one may be coming. But there are a lot of caveats that go along with that statement. First of all, for a yield curve inversion to be a good predictor of a recession, it has to last about three months or more – not a single day. And let's not forget that there has often been a long lag time between inversion and recession. Perhaps most importantly, an inverted yield curve may just be a product of disruption created by experimental monetary policy: major central banks have totally distorted their domestic bond markets. There are myriad other caveats to what is a simplistic rule of thumb. In short, I do not believe that investors should be panicking. Rather, I believe the ensuing months could be positive ones for equities. The Fed's more dovish stance should be supportive for risk assets – unless economic data deteriorates significantly.

Trump nominates a Fed critic to serve on its board

One more potential source of monetary policy disruption came last week, as President Donald Trump nominated perennial Fed critic Stephen Moore to a seat on the Federal Reserve Board of Governors. In the past, Moore criticized the Fed for having an ultra low rate policy; last year, he then criticized the Fed for raising rates. He has even advocated for the firing of Fed Chair Jay Powell.

You may recall that last week in my blog, I mentioned we could see **central banks come under attack by politicians**, and that we should be worried about the politicization of central banks because that could be very disruptive and generally problematic in the next crisis. Moore has many critics, including Greg Mankiw, a Harvard professor who was the chair of President George W. Bush's Council of Economic Advisers, who has come out in opposition to Moore's nomination. I expect some difficulties with a Senate confirmation. We will want to follow this situation closely.

Brexit update

It's commonly said that the definition of insanity is doing the same thing over and over again, but expecting a different outcome. I can't help but think of that definition as I watch UK Prime Minister Theresa May attempt to hold a third vote on her Brexit plan this week. May pulled off a nail-biter last week, securing a Brexit extension beyond March 29 from the European Union, with the length of the extension dependent on what happens next.

May plans on holding a third vote in Parliament on her plan, although House of Commons Speaker John Bercow has already announced it will have to be significantly different from the previous Brexit plans in order for him to allow the vote. From my perspective, it seems increasingly likely that the UK will hold another referendum on Brexit, but anything is clearly possible. The good news is that a "crash out" has been averted – at least for the time being.

What to look for in the coming week

- Brexit developments will be critical in the coming week. It is not clear whether May will be able to hold a third vote on her Brexit plan. She may finally relent and allow a referendum or, alternatively, there is even the possibility she could be ousted. Obviously we will want to follow the situation closely.
- US-China trade developments will also be important, given reports that China is hardening its positions. Negative news on the trade front could adversely impact an already fragile stock market.
- And because there is so much concern about global economic weakness, economic data points should be scrutinized, including:
  - US data: US consumer confidence, US fourth quarter gross domestic product, and US personal income and personal spending
  - Japanese data: employment, industrial production and retail sales
  - Chinese Purchasing Managers' Indexes
  - Given recent European data that has been disappointingly weak, we want to understand how significant European economic weakness is:
- German retail sales
- French gross domestic product
- Eurozone business and consumer sentiment
- German unemployment

My expectation is that, at the end of the week, as we assess this mosaic of economic data, some will certainly be disappointing, but I expect some positive surprises as well, painting a picture of what appears to be a modest global slowdown. Stay tuned.

Source

[1]CME FedWatch tool

Important information

The yield curve plots interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates to project future interest rate changes and economic activity. An inverted yield curve is one in which shorter-term bonds have a higher yield than longer-term bonds of the same credit quality. In a normal yield curve, longer-term bonds have a higher yield.

Gross domestic product is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

The CME FedWatch Tool analyzes the probability of upcoming Fed rate moves, using 30-day fed fund futures pricing data. Fed funds futures are financial contracts that represent the market's opinion of where the fed funds rate will be at a specified point in the future.

The CBOE Volatility Index® (VIX®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

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